ANNUAL REPORT

1997

Another year of

outstanding performance:

successful exploration

increased production

escalating revenue

consistent,

continued growth

SCARLET EXPLORATION INC.

CORPORATE OVERVIEW

SCO

Scarlet Exploration Inc., established in 1993, is a public junior oil and gas company involved in the acquisition, exploration and development of high-quality oil and gas reserves in western Canada. Since November 1995, with the introduction of a new management team, the Corporation has experienced an outstanding turnaround and continues to achieve consistent, strong performance. Scarlet Exploration's corporate office is located in Calgary, Alberta. The Corporation's shares are listed for trading on The Alberta Stock Exchange (symbol: SCO).

Change of Year End

To be consistent with general industry practice, the Corporation's fiscal year-end has been changed to December 31 from October 31 which results in a change of comparatives in the financial statements. This annual report covers the 14-month period ended December 31, 1997.

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ANNUAL MEETING

The Annual General and Special Meeting of the shareholders of Scarlet Exploration Inc. will be held at 3:00 pm, Wednesday, May 13, 1998, at The Westin Hotel, 320 - 4th Avenue S.W., Calgary, Alberta. Shareholders and others interested in the affairs of the Corporation are welcome to attend.

Abbreviations

ARTC	Alberta Royalty Tax Credit
boe	barrels of oil equivalent
boepd	barrels of oil equivalent per day
bopd	barrels of oil per day
mcf	thousand cubic feet (of natural gas)
mcf/d	thousand cubic feet per day
mmcf	million cubic feet
mmcf/d	million cubic feet per day
NGL	natural gas liquids

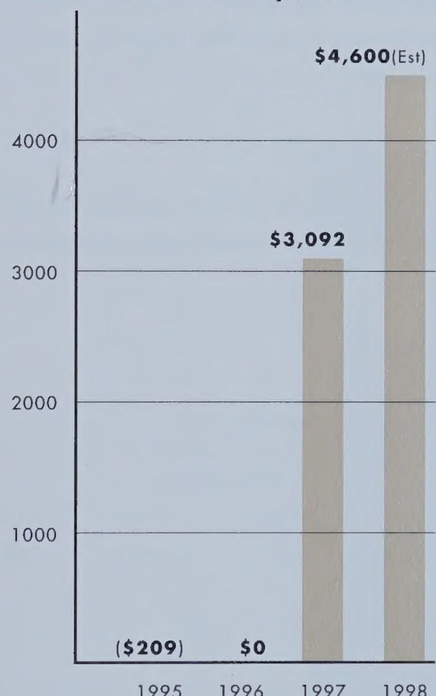
ASE: SCO

Exploration Inc. has gone through a dramatic
ear, its new management team turned around a negative
debt burden, acquired a core property, and began building

ntum that propelled the 1996 turnaround continued to
h in 1997. The Corporation now has three core properties,
ects, healthy cash flow and low finding costs.

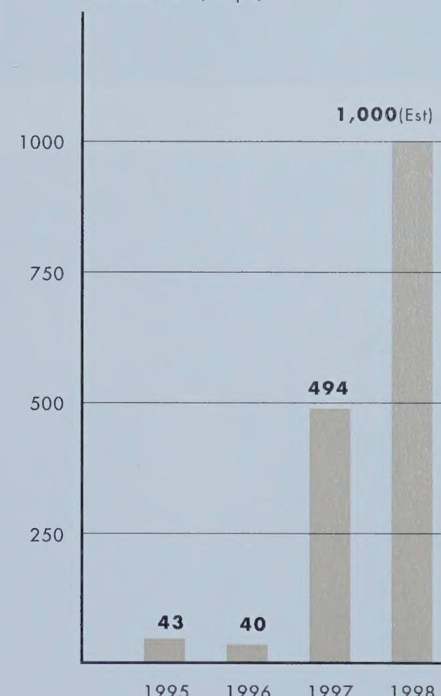
In two short, exhilarating years, Scarlet has achieved outstanding success. The management team — skilled, energetic, aggressive — is demonstrating its expert ability to consistently produce positive results. The numbers tell the story.

Cash Flow Summary ($000)



(95, 96: 12 mo ended Oct 31
97: 14 mo ended Dec 31
98: 12 mo ended Dec 31)

Production (boepd)



Cash Flow and Earnings Per Share (Basic)

	Cash Flow	Earnings Per Share
1998 Est	$ 0.28	$ 0.12
1997	$ 0.23	$ 0.14
1996	$ 0.00	$ 0.00
1995	$ (0.03)	$ (0.13)

Share Information At December 31, 1997

		Management Control
Issued and outstanding	15,249,250	13%
Fully diluted	17,264,250	18%

CORPORATE STRATEGY

Creating Value for the Future

Scarlet Exploration's mission is to maximize shareholder value by technically managing risk while optimizing acquisition, exploration and development of high-quality oil and gas reserves. The strategy to achieve its goals is based on three key elements:

Superior Technical Expertise

Scarlet's operational strategy is based on the strong technical expertise of its multi-disciplined professionals. The team uses the most advanced geologic, engineering and operating technologies available.

Sharply Focused Exploration & Development Strategy

Performance

We doubled production in 1997 and our goal is to do it again in '98.

Scarlet responsibly manages risk by combining high-impact exploration prospects with technically-driven development programs and low-risk exploitation prospects that exhibit superior upside potential. Of primary interest are exploration prospects in areas where hydrocarbon potential has been established, there is potential for multi-zone targets, and reserves are accessible with medium-depth drilling.

Highly Skilled, Diversified Team

The small, tightly knit team works efficiently and effectively, applying its superior technological skills and diversity of experience to identify and evaluate new opportunities quickly and accurately.

Land Holdings (Acres) At December 31, 1997

Alberta		Saskatchewan		Total	
Gross	Net	Gross	Net	Gross	Net
48,325	32,724	720	523	49,045	33,247

SCO at a Glance

	14-months ended Dec 31,1997	Year ended Oct 31, 1996
Gross oil and gas revenue	$ 5,661,586	$ 434,171
Sales of oil and NGL (avg)	480 bopd	39 bopd
Sales of natural gas (avg)	142 mcf/d	11 mcf/d
Operating expenses	$ 6.71/boe	$ 13.28/boe
General and administrative expenses	$ 3.16/boe	$ 15.89/boe
Cash flow/share from operations (basic)	$ 0.23	nil

AN EXTRAORDINARILY HIGH CALIBRE OF EXPLORATIONISTS

Many junior oil and gas companies rely on consultants to complement their staff teams, but Scarlet Exploration has taken this commonly used practice of hiring consultants to a new level — with its Explorers Club.

There is no clubhouse. No rule books. No minutes of meetings. Membership is limited and highly coveted. Members are an elite core of professionals, each and every one a highly qualified specialist. They are both newly schooled in leading edge technology and well seasoned in the rigors of the hunt for oil and gas.

The Explorers Club is a perfect fit with Scarlet Exploration's aggressive strategy and team approach. The Corporation is adding unparalleled expertise while maintaining its cost-efficient operating approach and keeping its goals focused. Besides, the Explorers Club injects a little fun into what, these days, can be a pretty bottom-line, button-down business.

SCARLET EXPLORATION EXPLORERS Club

The Explorers Club, summer 1997 (left to right):
Alan Jack, Ed Sorochuck, Gerald Wendland, Rob MacCuish, Davin Chandler, Helen Koziol.

PRESIDENT'S REPORT

Alan D. Jack, P. Eng.

President, Chairman & Chief Executive Officer

To Our Shareholders:

Scarlet Exploration Inc. achieved new levels of success in 1997 — a year marked by many milestone events. By the end of October 1997, we had achieved our goals for cash flow and production.

This achievement validates the turn-around which began in 1996 and firmly places Scarlet on the path to continued success.

As you read through our 1997 annual report, please remember that the fiscal year-end for the Corporation has been changed to December 31 which results in a change of comparatives in the financial statements. This report covers the 14-months ended December 31, 1997 which is compared to the year ended October 31, 1996.

A Year of Success & Accomplishment

While the numbers for 1997 are based on 14 months and those for 1996 on 12 months, the improvements are significant, with gross oil and gas revenue leading the way — rocketing to $5.7 million at December 31, 1997 compared to $434,000 for the year ended October 31, 1996. Operating expenses were reduced to $6.71/boe for the 14-months ended December 31, 1997 from $13.28/boe for the year ended October 31, 1996.

There are many positive numbers which reflect our accomplishments this past year — drilling success, average daily production, land holdings — and I'm proud of them all. But the ones I like best are cash flow per share, $0.23, and net income per share, $0.14, for the 14-months ended December 31, 1997 — because these demonstrate the value we are building in the Corporation.

Expanding Our Horizons

Scarlet began establishing a foundation of solid assets in November 1996 with the acquisition of our initial properties at Zama / Sousa in the Rainbow Lake region which became our first core area.

In 1997, we increased our holdings substantially, developing a second core area at Paddle River, Alberta and a third one in southeastern Saskatchewan. In keeping with our plan to increase gas production and reserves, several gas prospects in Alberta were among our land acquisitions.

Honing Our Competitive Edge

During the past year, it has been interesting to note changes in how the investment community looks at Scarlet. The turn-around caught the attention of brokers and analysts; now, our ongoing accomplishments are being followed closely.

There is no question that Scarlet is out-performing many of its peers in the industry. We have a proven track record. We set realistic goals and we achieve them. We continue to prove the effectiveness of our strategy. We are constantly honing our talents and skills, building on our strengths.

Highlights of the Past Year

- We had tremendous success in Zama/Sousa and there is potential for more.
- We established two new core areas with a land position of greater than 12,000 gross acres in less than six months and potential to earn up to 29,000 additional gross acres.
- We have begun to complement our oil production with high-quality gas prospects.
- The concept of our Explorers Club is working extremely well: the Club generates high-impact prospects in all core regions; management tenaciously pursues the opportunities.
- Strong technical expertise coupled with the employment of advanced technologies allow us to realize the maximum potential of properties in a timely fashion.
- We have the financial strength to comfortably secure and evaluate all opportunities.
- We have the financial controls to manage our future responsibly.

The Year Ahead

Everything we have done in the past two years has been aimed at building value for our shareholders; everything we do in the future will also be focused on this goal.

I look forward to reporting continued success in the coming year. In the meantime, I would like to take this opportunity to thank the members of our Board of Directors, our employees, the members of the Explorers Club, our associates and contractors, for their contributions to Scarlet's achievements.

Alan Jack

Alan D. Jack, P.Eng.
Chairman & Chief Executive Officer
Calgary, Alberta

March 19, 1998

OPERATIONS REPORT

Gerald J. Wendland, P.Geol.

Vice President,
Exploration

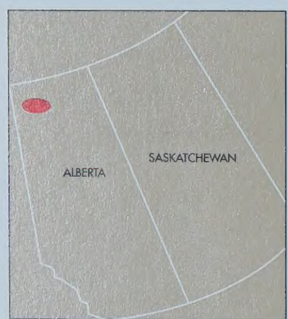
ZAMA/SOUSA AREA – RAINBOW LAKE REGION

The foundation for Scarlet's turn-around, our acquisition in the Zama/Sousa area made in late 1996, gave the Corporation a working interest in existing oil production and facilities, and a working interest in 28.5 sections of land with drilling potential. It also provided the foundation for the Rainbow Lake region to become our first core area.

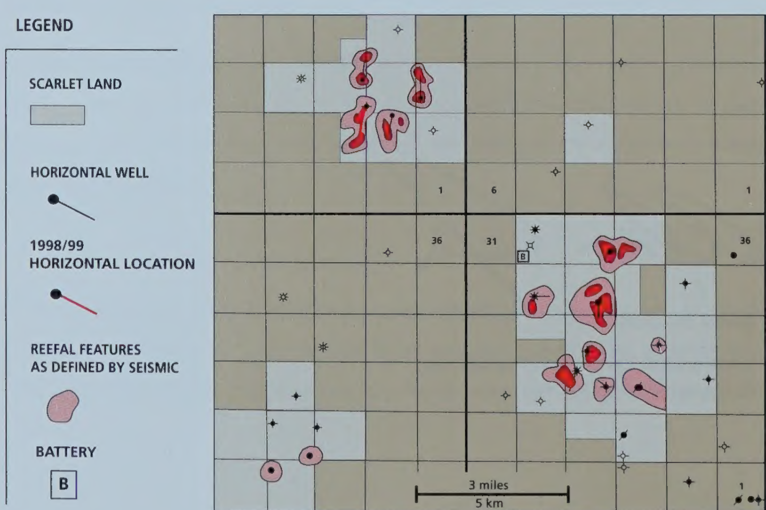
Through extensive reworking and interpretation of 3-D seismic, we identified ten re-entry candidates to drill horizontally. Between December 1996 and March 1997, five of these locations were horizontally drilled, resulting in reserve additions of 396,000 barrels (net to Scarlet as evaluated by Sproule Associates Limited, March 31, 1997) and a production increase of 535 bopd net to Scarlet. Finding costs for these increases were $3.05/barrel.

Subsequent to these events, a production optimization program was implemented to reduce production declines which are inherent in wells in this area. Production was successfully stabilized at approximately 500 bopd net to the Corporation.

During 1997, additional acreage was secured on this property and further 3-D seismic evaluation was completed. For the winter of 1997-98, an additional horizontal location was added to the remaining five wells to be drilled. Plans were also made to re-enter some existing horizontal wellbores to drill new lateral legs.



ZAMA / SOUSA



Due to mild weather conditions precipitated by El Niño, the 1997-98 winter season started late and has not been ideal for drilling. Five horizontal locations were proposed for this season and four have already been completed. Of the four wells, two were drilled as farm-out locations (Scarlet has a working interest position after payout) and two were drilled by Scarlet. Both of the latter wells have been completed as oil wells with initial rates in excess of 400 bopd (gross). The fifth well is currently drilling and will be completed by the end of March.

High Netbacks

We understand the importance of maintaining a high netback. With a 1997 average netback of $15, Scarlet is competing head-on with larger companies whose netbacks meet industry standards of $8 - 10.

For the winter of 1998-99, there is still one horizontal location to be drilled, as well as one horizontal wellbore extension planned. Some of the existing locations also present opportunities to drill a second leg in order to maximize oil recovery and increase production rates and revenue.

EAST RAINBOW AREA – RAINBOW LAKE REGION

Fueled by success in the Zama/Sousa area, Scarlet employed its geologic and operations expertise to other areas of the Rainbow Basin. In the spring of 1997, we negotiated a multi-parcel farm-in in the East Rainbow area of this core region.

Three-dimensional seismic was obtained for the East Rainbow prospect and numerous opportunities were identified. The first candidate was drilled in July 1997 and was abandoned. The second candidate was completed in the fall and was placed on production at 150 bopd (120 bopd net). This location proved up a new prospect area.

Combined with the Zama/Sousa area, Scarlet was successful in completing six locations this season in the Rainbow Lake region.

Going over prospects in the "pit" (left to right): Rob MacCuish, Ed Sorochuck, Davin Chandler, Gerald Wendland, Helen Koziol, Dan Stratton.

PADDLE RIVER REGION

In July 1997, Scarlet began acquiring acreage in the Paddle River region which has since become the Corporation's second core area. The Paddle River region offers year-round drilling and potential for both oil and gas. The way this region became a core area for Scarlet demonstrates our operational strategy and how we can move quickly to capitalize on opportunity.

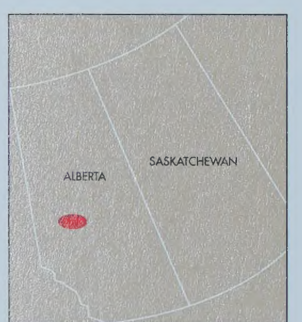
We initially liked the region for its multi-zone potential, medium depth drilling and year round access. It was also an area that had not attracted a lot of interest; land sale prices had not yet begun to "heat up".

Technical Expertise

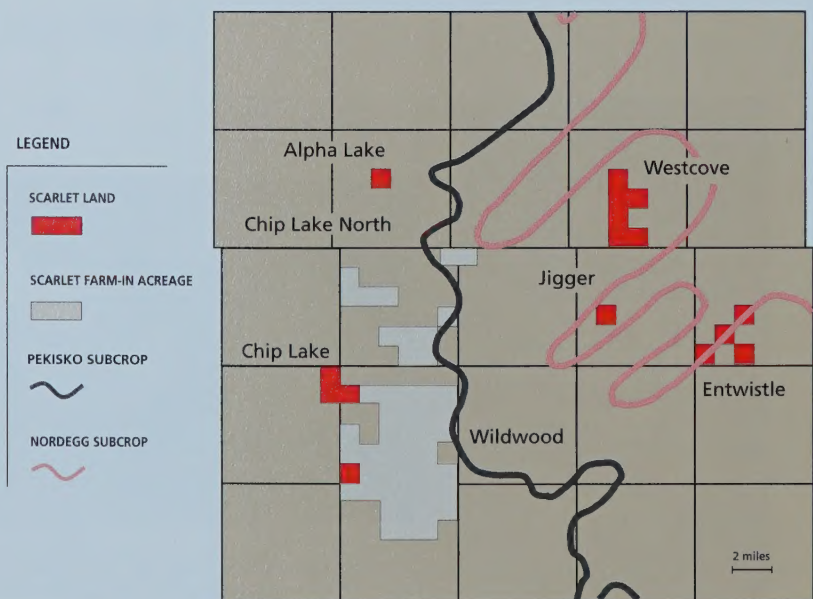
Our people are our greatest competitive advantage. We've known from the outset that building a core team of exceptional professional and technical experts was critical to our success.

Members of Scarlet's Explorers Club had been mapping and evaluating this area for six months before we moved in to pursue the opportunities we had identified. Within four months, Scarlet had acquired an acreage position in excess of 11,700 acres (7,100 net) over five prospect areas. In addition, by December 1997, Scarlet had negotiated two farm-ins — one covering four sections of land (2,530 gross acres) and the other, jointly obtained with an industry partner, covering 42 sections of land (26,568 gross acres).

Within five months, Scarlet progressed from not having a position at all in this region to being a major player and operator in an exciting growth area.



PADDLE RIVER



ENTWISTLE PROSPECT – PADDLE RIVER REGION

One of the first prospects identified by the Explorers Club in the Paddle River region, Entwistle yielded Scarlet its first production from the area via an existing wellbore. The well, a recompletion on an existing wellbore, was completed in the fall of 1997. Although it has not been fully evaluated, the well encouraged Scarlet and its partners to drill an offsetting horizontal wellbore.

The horizontal well reached total depth in December 1997. Although it encountered mechanical problems on completion, it also encountered oil in the target zone. We have not yet finished work on this well; however, we are confident that it will become a producer. The horizontal well also revealed a second zone of potential oil. This has prompted Scarlet to go back to the first well and perform a completion on the second zone in that wellbore. At the time of writing, recompletion operations are not final, but initial results are encouraging as oil has been encountered from the second target zone.

Meanwhile, Scarlet has increased its land position on this prospect. Other drilling locations have been identified and will be pursued upon final evaluation of the two existing wells.

CHIP LAKE NORTH PROSPECT – PADDLE RIVER REGION

Finding and Development Costs

Our finding and development costs are among the lowest in the industry. At $3.88/boe, our costs are well below the industry average of $6-7/boe.

This prospect is located to the west of Entwistle and targets a different zone. In November 1997, a four-section farm-in was negotiated with the land holder and in February 1998, Scarlet drilled a well to earn a working interest in all four sections. The well encountered a substantial oil column in the target zone and, although it had completion problems, we are pursuing options to obtain production from this location. Offsetting acreage to this parcel is also prospective and we are attempting to secure this land.

Drilling Results 14-months ended Dec 31, 1997

Total Wells	Oil Wells	Gas Wells	Abandoned	Success Ratio
9	6	1	2	78%

WILDWOOD PROSPECT - PADDLE RIVER REGION

This is a natural gas prospect that has been generated internally by our Explorers Club. Land availability in this area was extremely tight, but tenacious pursuit resulted in securing a 42 section (26,568 gross acres) farm-in from land holders in this area.

To secure the Wildwood property, Scarlet teamed with an industry partner. We have committed to drilling two wells to earn six sections (gross) of land with options on the balance.

Scarlet's ongoing strategy will be to high-grade the lands further on the basis of drilling results and only secure acreage that offers good potential for production. This is a very high-impact prospect that could result in significant gas reserves if successful. We have minimized our risk in this prospect by teaming with a quality partner and negotiating a high land earning for every well drilled. The first well has been drilled and is waiting on completion.

Risk Ratios

We measure every project for its risk against return on investment capability. We have consistently selected projects with minimal risk and superior rates of return.

Left to right: Lois Booy (Land Administrator), Rick Ironside (Operations Manager), Shaunna Haas (Manager, Corporate Affairs), Alan Jack, Peter Lawrence (Senior Financial Accountant), Nora Blakney.

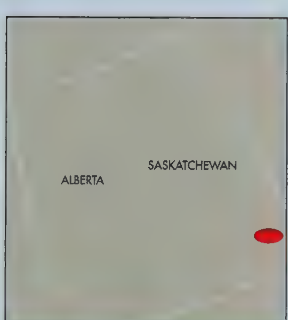
SOUTHEASTERN SASKATCHEWAN REGION

This area of western Canada is well known for its prolific accumulations of oil from excellent reservoirs at shallow depths. Scarlet's Explorers Club intends to exploit this region by employing 3-D seismic and horizontal drilling to further enhance the potential of these producing zones.

In three short months Scarlet acquired a land position of 720 acres (523 net) on the Browning, North Midale and West Heward prospects. These acquisitions also resulted in securing net production of approximately 50 bopd.

Not obtained for their existing production, these properties are being evaluated with 3-D seismic with an eye to drilling horizontal wells to enhance production and increase reserve recovery — an example of how state-of-the-art technology can result in increased production from areas once considered too mature to contribute in a meaningful way.

Once seismic evaluation has been completed, we plan to commence drilling on these properties in the summer and fall of 1998.



SOUTHEAST SASKATCHEWAN

LAMPMAN PROSPECT - SOUTHEASTERN SASKATCHEWAN REGION

In the fall of 1997, Scarlet secured a one section (640 acres gross) farm-in on this prospect. Three-dimensional seismic identified two prospective targets on this acreage. Scarlet has drilled a horizontal well on this property and is waiting on production results to fully evaluate this prospect. We have identified a number of additional prospects in this region which will be pursued in upcoming months.

GAS PROSPECTS

In 1997, Scarlet identified and secured several gas prospects in various areas of Alberta. Over the course of the winter, we drilled three wells targeting gas in northern Alberta: the Snowfall prospect in the Chinchaga area, LaGlace on the Peace River Arch, and Ft. Kent in the Cold Lake area.

Earnings

With earnings per share of $0.14 (basic) and cash flow per share of $0.23 (basic), we're ahead of most companies in our peer group.

At Snowfall, Scarlet encountered a gas-bearing carbonate; the well is capable of producing 750 mcf/d and will be placed on production later this year.

The Ft. Kent well encountered a gas-bearing sand and has been tied in. It is capable of producing at a restricted rate of 1.0 mmcf/d.

At LaGlace, Scarlet encountered four metres of gas-prone sand. This well has undergone initial completion and is being evaluated.

Gerald J. Wendland, P.Geol.

Vice President,
Exploration

Scarlet Exploration Inc.'s fiscal year-end has been changed to December 31 from October 31. This results in a change of comparatives in the financial statements. The financial discussion included in this Annual Report is for the 14-month period ended December 31, 1997 which is compared to the year ended October 31, 1996.

Nora Blakney, CMA
Controller

Oil and Gas Revenues

Revenues before royalties for the 14-months ended December 31, 1997 was $5,661,586 compared to $434,171 for the year ended October 31, 1996. Crude oil and NGL revenue for the period was $5,529,513 and natural gas revenue was $132,073 for the 14-months ended December 31, 1997 compared to crude oil and NGL revenue of $431,169 and natural gas revenue of $3,002 for the year ended October 31, 1996.

The average sales price of oil for the 14-months ended December, 1997 was $27.06 / barrel ($29.26 in 1996) and the average sales price of natural gas was $2.18/mcf ($1.19 in 1996). The Corporation had a hedging program in place to sell 9,000 barrels of oil per month at a price of US$21.00 / barrel for the period April 1, 1997 to December 31, 1997.

Sales of oil and NGL averaged 480 bopd during the 14-months ended December 31, 1997 compared to 39 bopd during the year ended October 31, 1996. Natural gas sales during the 14-months ended December 31, 1997 averaged 142 mcf/d versus 11 mcf/d for the year ended October 31, 1996.

The significant increases in oil revenues and oil production are a direct result of the successful drilling and completion of five producing oil wells at Zama / Sousa and one productive oil well at East Rainbow during 1997, as well as the acquisition of producing properties in southeast Saskatchewan.

Royalties

Royalties, net of ARTC, were $317,896 for the 14-months ended December 31, 1997 compared to $24,339 for the year ended October 31, 1996. The increase is due to wells which were acquired and successfully drilled and are subject to Crown and freehold royalties.

Operating Expenses

Operating expenses were $1,414,587 ($6.71/boe) for the 14-months ended December 31, 1997 compared to $195,082 ($13.28/ boe) for the year ended October 31, 1996. The reduction in operating expenses per boe is the direct result of the Corporation's swap of non-performing gas assets for oil producing assets in 1996 and the development of core areas at Zama / Sousa, East Rainbow and southeast Saskatchewan during 1997.

Interest and Other Income

Interest and other income increased to $31,049 for the 14-months ended December 31, 1997 from $18,505 for the year ended October 31, 1996. Interest and other income consisted of interest earned on funds invested in short-term investments.

General and Administrative

General and administrative expenses, after overhead and capitalized costs, were $667, 171 ($3.16/boe) for the 14-months ended December 31, 1997 compared to $233,488 ($15.89/boe) for the year ended October 31, 1996. The increase in general and administrative expenses reflects higher costs for personnel, promotions and office rent. The decrease in general and administrative expenses per boe is the result of significant increased production in the Zama / Sousa area.

Interest Expense

Interest expense for the 14-months ended December 31, 1997 was $200,825 compared to nil for the year ended October 31, 1996. The increase reflects the establishment and utilization of the bank revolving operating loan to fund capital expenditures.

Depletion, Depreciation and Amortization

Depletion, depreciation and amortization was $1,295,757 for the 14-months ended December 31, 1997 compared with the year ended October 31, 1996 when the Corporation recorded a depletion and depreciation provision of $148,123. The increase in depletion, depreciation and amortization reflects the higher production in 1997.

Funds from Operations and Net Income

Funds from operations increased to $3,092,156 for the 14-months ended December 31, 1997 as compared to ($233) for the year ended October 31, 1996. Basic funds from operations per common share was $0.23 for the 14-months ended December 31, 1997 compared to nil for the year ended October 31, 1996.

Net income was $1,796,399 or $0.14 per share (basic) for the 14-months ended December 31, 1997 compared to the net income of $9,644 or nil per share (basic) for the year ended October 31, 1996.

The increase in funds from operations and net income is the result of the property acquisitions and drilling during 1996-1997 — five producing oil wells at Zama / Sousa, one oil well at East Rainbow, and the acquisition of the oil producing properties in southeast Saskatchewan.

Capital Expenditures

The capital expenditure program for the 14-months ended December 31, 1997 was $7,007,127 compared to $6,360,582 for the year ended October 31, 1996. Capital expenditures for the 14-months ended December 31, 1997 included drilling activities and property acquisitions. The 1997 capital program was funded from a combination of cash flow, bank debt and the issuance of flow-through special warrants.

Liquidity and Capital Resources

The Corporation has available a demand revolving reducing operating loan with a Canadian financial institution totaling $5,000,000, bearing interest at the bank's prime rate plus 1.0% per annum. Repayment starts February 1, 1998, with 25 monthly principal reductions of $200,000 and all amounts due under the loan are to be repaid by February of the year 2000. The operating loan is secured by a general security agreement covering all present and after acquired property of the borrower, a first fixed and floating charge debenture in the minimum amount of $6,000,000 over assets in the Corporation, an environmental indemnity and assignment of necessary insurance.

On January 21, 1998, the Corporation entered into a $10,000,000 demand loan facility with a Canadian financial institution for the acquisition of oil and gas properties and for the subsequent development and exploration of such properties. This facility requires specific approval by the Canadian financial institution of each amount which the Corporation would be entitled to drawdown or which the Corporation could use to fund any acquisition. The specific approval granted also provides for the security which would be required for the advances and the terms of repayment required. No amounts have been drawn on this facility.

On November 26, 1997, the Corporation entered into an agency agreement for the creation, issuance and sale of 800,000 Special Warrants on a flow-through basis at a price of $ 1.25 per Special Warrant. Each Special Warrant entitles the holder to acquire, upon exercise, one Common Share of the Corporation at no additional cost. Gross proceeds on the sale of the Special Warrants were $1,000,000. The Agent's commission of $0.09375 per Special Warrant totaling $75,000 was paid out of working capital. A final prospectus qualifying the issuance of the 800,000 Common Shares was receipted on March 19, 1998 resulting in the deemed exercise of these Special Warrants.

The Corporation intends to fund its ongoing operations, capital expenditures and property acquisitions from cash flow, bank debt and equity financing.

Risk Management

There are many inherent risks within the petroleum and natural gas industry including fluctuating commodity prices, exploration risks, product demand, transportation, restrictions, exchange and interest rate fluctuations, strong competition for acquisitions, and governmental regulatory risks. Scarlet will manage certain of these risks:

- focusing on high working interest and operated properties in order to ensure efficient and cost effective operations
- maximizing the present value of reserves by focusing on plays with immediate cash flow
- maintaining a strong financial position
- striving for a mix of production in different areas with a primary focus on attractive net backs
- concentrating exploration activities on undeveloped lands on trend with current producing areas
- employing risk management instruments to minimize exposure to the volatility of commodity prices, interest rates and foreign exchange
- maintaining a team of highly qualified and motivated professionals who have a vested interest in the success of the Corporation
- maintaining an insurance program consistent with industry practice to protect against losses due to accidental destruction of assets, well blowouts, pollution, and other business interruptions.

Management periodically utilizes certain financial instruments to hedge its exposure to commodity price fluctuations on a portion of its crude oil and natural gas production. The Corporation continuously monitors the prices and rates and, when appropriate, utilizes such instruments.

The year 2000 is approaching and Scarlet is preparing for the new millenium. The year 2000 computer issue results from the computer industry's use of two digits instead of four to identify a given year; therefore, January 1, 2000 might be interpreted by computer systems as January 1, 1900.

Scarlet is reviewing the impact of year 2000 computer related issues and is actively developing an action plan to ensure compliance in a timely manner and to minimize the effects on the Corporation. Scarlet will review all computer software and hardware, communication equipment and field facilities for year 2000 compliance. Scarlet does not expect the financial impact to be material to the Corporation.

All of the information in this annual report is the responsibility of management. The accompanying financial statements of Scarlet Exploration Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles. The financial information elsewhere in the annual report has been reviewed to ensure consistency in all material respects with that in the financial statements.

Scarlet Exploration Inc. maintains appropriate systems of internal control to give reasonable assurance that transactions are appropriately authorized, assets are safeguarded from loss or unauthorized use, and financial records provide reliable and accurate information for the preparation of financial statements.

KPMG, an independent firm of chartered accountants, has been engaged to examine the financial statements and provide their Auditors' Report. This report is presented with the financial statements.

The directors are responsible for ensuring that management fulfils its responsibilities for financial reporting and internal control. The directors exercise this responsibility through the Audit Committee. This committee, which is comprised of non-management directors, meets with management and the external auditors to satisfy itself that management responsibilities are properly discharged and to review the financial statements before they are presented to the directors for approval. The financial statements have been approved by the board of directors on the recommendation of the Audit Committee.

Alan D. Jack, P.Eng.
President and Chief Executive Officer

Nora Blakney, CMA
Controller

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Scarlet Exploration Inc. as at December 31, 1997 and October 31, 1996 and the consolidated statements of operations and retained earnings (deficit) and changes in financial position for the 14-months ended December 31, 1997 and the year ended October 31, 1996. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 1997 and October 31, 1996 and the results of its operations and the changes in its financial position for the 14-months ended December 31, 1997 and the year ended October 31, 1996 in accordance with generally accepted accounting principles.

KPMG

Chartered Accountants

Calgary, Canada
February 18, 1998

SCARLET EXPLORATION INC.
Consolidated Balance Sheets

		December 31, 1997		October 31, 1996
Assets				
Current assets:				
Cash and term deposits	$	116,405	$	962,935
Cash held in trust (note 2)		-		500,000
Accounts receivable (note 6)		1,618,410		1,352,598
Prepaid expenses		80,068		109,643
		1,814,883		2,925,176
Capital assets (note 3)		10,088,148		4,578,792
	$	11,903,031	$	7,503,968
Liabilities and Shareholders' Equity				
Current liabilities:				
Accounts payable and accrued liabilities (note 2)	$	1,464,693	$	4,350,211
Current portion of long-term debt (note 4)		1,100,000		-
		2,564,693		4,350,211
Long-term debt (note 4)		2,800,000		-
Future site restoration and abandonment (note 3)		225,077		22,091
Shareholders' equity:				
Share capital (note 5)		5,585,832		4,200,636
Retained earnings (deficit)		727,429		(1,068,970)
		6,313,261		3,131,666
Commitment (note 8)				
Subsequent event (note 4)				
	$	11,903,031	$	7,503,968

On behalf of the Board:

Alan D. Jack, Director

Lorenzo Donadeo, Director

See accompanying notes to consolidated financial statements.

SCARLET EXPLORATION INC.

Consolidated Statements of Operations and Retained Earnings (Deficit)

	14-months ended December 31, 1997	Year ended October 31. 1996
Revenues:		
Oil and gas sales, net of royalties	$ 5,343,690	$ 409,832
Interest and other income	31,049	18,505
	5,374,739	428,337
Expenses:		
Production	1,414,587	195,082
Depletion, depreciation and amortization	1,295,757	148,123
General and administrative (note 6)	667,171	233,488
Interest	200,825	-
	3,578,340	576,693
Income (loss) before gain on sale of capital assets	1,796,399	(148,356)
Gain on sale of capital assets	-	158,000
Net income	1,796,399	9,644
Deficit, beginning of period	(1,068,970)	(1,078,614)
Retained earnings (deficit), end of period	$ 727,429	$ (1,068,970)
Net income per common share:		
Basic	$ 0.14	$ 0.00
Fully diluted	$ 0.13	$ 0.00

See accompanying notes to consolidated financial statements.

SCARLET EXPLORATION INC.

Consolidated Statements of Changes in Financial Position

	14-months ended December 31 1997	Year ended October 31 1996
Cash provided by (used in):		
Operations:		
Net income	$ 1,796,399	$ 9,644
Items not affecting cash:		
Depletion, depreciation and amortization	1,295,757	148,123
Gain on sale of capital assets	-	(158,000)
Funds from operations	3,092,156	(233)
Change in non-cash working capital items related to operations	(503,000)	(817,863)
	2,589,156	(818,096)
Investing:		
Acquisition of capital assets	(7,007,127)	(6,360,582)
Proceeds on the sale of capital assets	405,000	2,532,744
Change in non-cash working capital items related to investing	(2,618,755)	3,609,747
	(9,220,882)	(218,091)
Financing:		
Increase in long-term debt	3,900,000	-
Issue of common shares	2,330,041	649,000
Issue (conversion) of special warrants	(700,000)	1,700,000
Common share and special warrant issue costs	(244,845)	(67,689)
	5,285,196	2,281,311
Increase (decrease) in cash position	(1,346,530)	1,245,124
Cash position, beginning of period	1,462,935	217,811
Cash position, end of period	$ 116,405	$ 1,462,935
Consisting of:		
Cash and term deposits	$ 116,405	$ 962,935
Cash held in trust	-	500,000
	$ 116,405	$ 1,462,935
Funds from operations per common share:		
Basic	$ 0.23	$ 0.00
Fully diluted	$ 0.21	$ 0.00

See accompanying notes to consolidated financial statements.

SCARLET EXPLORATION INC.

Notes to Consolidated Financial Statements
14-months ended December 31, 1997 and the year ended October 31, 1996

General:

Scarlet Exploration Inc. (the "Corporation") was incorporated under the Business Corporations Act (Alberta) on July 5, 1993. The Corporation is engaged in the business of investigating, acquiring, exploring and developing petroleum and natural gas properties.

1. Significant accounting policies:

(a) Basis of consolidation:

The consolidated financial statements include the accounts of the Corporation and its wholly-owned subsidiary.

(b) Petroleum and natural gas properties:

The Corporation follows the full cost method of accounting for petroleum and natural gas operations whereby all costs of exploring and developing petroleum and natural gas properties and related reserves are capitalized into a single Canadian cost centre. Such costs include land acquisition costs, costs of drilling both productive and non-productive wells, geological and geophysical expenses and well equipment.

Gains or losses on the disposition of petroleum and natural gas properties are not ordinarily recognized except under circumstances which result in a major revision of depletion rates.

Capitalized costs, together with estimated future capital costs associated with proven reserves, are depleted using the unit-of-production method based on estimated proven reserves of petroleum and natural gas before royalties as determined by an independent engineer. For purposes of the depletion and depreciation calculation, natural gas reserves and production are converted to equivalent volumes of crude petroleum based on their approximate relative energy content.

The Corporation applies a "ceiling test" to capitalized costs to ensure that such costs do not exceed future net revenues from estimated production of proven reserves, using prices and costs in effect at the Corporation's period end. Future net revenues are calculated after deducting general and administrative, financing, income taxes and future site restoration and abandonment costs.

Substantially all of the Corporation's exploration and production activities are conducted jointly with others and accordingly, the accounts reflect only the Corporation's proportionate interest in such activities.

(c) Office leaseholds and equipment:

Office leaseholds and equipment are recorded at cost and depreciated using the straight-line method over five years, representing their estimated useful life.

(d) Future site restoration and abandonment:

Estimated future site restoration and abandonment costs are provided for over the life of the proven reserves on a unit-of-production basis. Costs are estimated each period by management based on current regulations, costs, technology and industry standards. The annual charge is included in the provision for depletion, depreciation and amortization and actual site restoration and abandonment expenditures are charged to the accumulated provision account as incurred.

(e) Deferred financing costs:

Financing costs associated with the issue of long-term debt are deferred and amortized over the term of the debt.

(f) Financial instruments:

The Corporation periodically utilizes certain financial instruments to hedge its exposure to commodity price fluctuations on a portion of its crude oil and natural gas production. Gains and losses on these transactions are reported as adjustments to revenue when the related production is sold.

(g) Flow-through shares:

The resource expenditure deductions for income tax purposes related to exploratory and development activities funded by flow-through share arrangements are renounced to investors in accordance with income tax legislation. Petroleum and natural gas properties and share capital are reduced by the estimated benefit of the renounced deductions when the expenditures are incurred.

(h) Per share amounts:

Per share amounts are calculated using the weighted average number of common shares outstanding during the period. Fully diluted income (loss) per share reflect the dilutive effect of the exercise of stock options.

(i) Use of estimates:

The amounts recorded for depletion, depreciation and amortization of capital assets and other assets and the provision for future site restoration and abandonment costs are based on estimates. The ceiling test calculation is based on such factors as estimates of proven reserves, production rates, petroleum and natural gas prices and future costs. By their nature, these estimates are subject to measurement uncertainty and may impact the financial statements of future periods.

2. Cash held in trust:

At October 31, 1996, the Corporation had cash held in trust totaling $500,000, the use of which was restricted to facility repairs and improvements associated with a certain property. Of this amount, $75,000 was due to a corporation in which the president of the Corporation was a director.

3. Capital assets:

December 31, 1997	Cost	Accumulated Depletion, Depreciation and Amortization	Net Book Value
Petroleum and natural gas properties	$ 11,135,245	$ 1,177,860	$ 9,957,385
Office leaseholds and equipment	126,141	14,943	111,198
Other	45,565	26,000	19,565
	$ 11,306,951	$ 1,218,803	$ 10,088,148
October 31, 1996			
Petroleum and natural gas properties	$ 4,641,861	$ 125,158	$ 4,516,703
Office leaseholds and equipment	32,398	874	31,524
Other	30,565	-	30,565
	$ 4,704,824	$ 126,032	$ 4,578,792

SCARLET EXPLORATION INC.

Notes to Consolidated Financial Statements

14-months ended December 31, 1997 and the year ended October 31, 1996

During the fourteen months ended December 31, 1997 general and administrative expenditures relating to exploration and development totaling approximately $332,000 (year ended October 31,1996 - $nil) were capitalized. Unevaluated properties not subject to depletion as at December 31, 1997 totaled approximately $1,468,000 (October 31, 1996 - $446,000). The carrying value of the petroleum and natural gas properties has been reduced by $760,722 (year ended October 31, 1996 - $nil), representing the tax benefits of exploration and development expenditures renounced to shareholders in connection with flow-through share agreements.

As at December 31, 1997, the estimated future site restoration and abandonment costs to be accrued over the remaining proven reserves are approximately $1,739,000.

4. Long-term debt:

	December 31 1997	October 31 1996
Demand revolving loan bearing interest at the lender's prime rate plus 1% per annum payable monthly and with the principal repayable in monthly payments of $200,000 commencing February 1, 1998, based upon the facility maximum	$ 3,900,000	$ -
Less current portion	(1,100,000)	-
	$ 2,800,000	$ -

The demand revolving loan is a $5,000,000 credit facility and is secured by a general security agreement covering all present and after acquired property of the borrower, a first fixed and floating charge debenture in the minimum amount of $6,000,000 over assets in the Corporation, an environmental indemnity and assignment of necessary insurance.

The Corporation is required to make the following annual principal repayments:

1998	$ 1,100,000
1999	2,400,000
2000	400,000
	$ 3,900,000

On January 21, 1998 the Corporation entered into a $10,000,000 demand loan facility with a Canadian financial institution for the acquisition of oil and gas properties and for the development and exploration of such properties thereafter. This facility requires specific approval by the Canadian financial institution of each amount which the Corporation would be entitled to drawdown or which the Corporation could use to fund any acquisition. The specific approval granted also provides for the security which would be required for the advances and the terms of repayment required therefor. No amounts have been drawn on this facility.

5. Share capital:

(a) Authorized:

(i) Unlimited number of preferred shares

(ii) Unlimited number of common shares

(b) Issued:

	December 31 1997		October 31 1996	
	Number	Amount	Number	Amount
Common shares:				
Balance, beginning of period	9,810,000	$ 2,535,636	7,885,000	$ 1,919,325
Issued upon conversion of special warrants	3,400,000	1,665,000	-	-
Issued for cash on a flow-through basis	1,000,000	1,100,000	-	-
Issued upon exercise of options	1,039,250	290,763	125,000	29,000
Issued for cash	-	-	1,800,000	620,000
Tax benefit relating to renounced expenditures	-	(490,000)	-	-
Issue costs	-	(138,895)	-	(32,689)
Balance, end of period	15,249,250	4,962,504	9,810,000	2,535,636
Special warrants:				
Balance, beginning of period	3,400,000	1,665,000	-	-
Conversion to common shares	(3,400,000)	(1,665,000)	-	-
Issued for cash on a flow-through basis	800,000	1,000,000	-	-
Issued for cash	-	-	3,400,000	1,700,000
Tax benefit relating to renounced expenditures	-	(270,722)	-	-
Issue costs	-	(105,950)	-	(35,000)
Balance, end of period	800,000	623,328	3,400,000	1,665,000
		$ 5,585,832		$ 4,200,636

SCARLET EXPLORATION INC.

Notes to Consolidated Financial Statements

14-months ended December 31, 1997 and the year ended October 31, 1996

5. Share capital (continued):

(c) Special warrants:

Each special warrant entitles the holder to acquire, at no additional cost, one common share of the Corporation.

(d) Stock option plan:

The Corporation has a stock option plan for its directors, officers, employees and consultants.

The changes in outstanding options were as follows:

Outstanding, October 31, 1995	333,750
Issued	1,025,000
Expired/cancelled	(251,250)
Exercised	(125,000)
Outstanding, October 31, 1996	982,500
Issued	1,081,750
Expired/cancelled	(10,000)
Exercised	(939,250)
Outstanding, December 31, 1997	1,115,000

Each of the options outstanding at December 31, 1997 enable the holder to acquire one common share of the Corporation at prices ranging from $0.64 to $1.23 per share and expire on various dates to December, 2002.

In addition the Corporation has granted an option to an investment dealer to acquire up to 100,000 common shares at an exercise price of $1.10 on or before October 9, 1998 in conjunction with a financing which occurred in December 1996.

6. Related party transactions:

(a) Joint activities:

(i) The Corporation carries on development and production activities with companies controlled by officers of the Corporation. The aggregate balance owing to the Corporation at December 31, 1997 is $102,493 (October 31, 1996 - $nil). The transactions from which the net receivables arose were rendered at normal commercial rates.

(ii) During the year ended October 31, 1996, the Corporation sold an interest in a property for cash consideration totaling approximately $270,000 to a corporation in which the president of the Corporation was a director. Consistent with industry practice, the Corporation carries on development and production activities in joint ventures with this corporation. The aggregate balance owing from this corporation as at October 31, 1996 was $248,685.

6. Related party transactions (continued):

(c) Legal services:

During the year ended October 31, 1996, the Corporation incurred $39,704 for legal services to a law firm in which a former director of the Corporation practices law.

(d) Property acquisition:

During the year ended October 31, 1996, the Corporation purchased a 100% interest in a property from a corporation owned and controlled by the president and vice-president of the Corporation for cash consideration of $62,500, representing the estimated fair market value of the property.

7. Income taxes:

The provision for income tax differs from the result which would have been obtained by applying the combined federal and provincial income tax rates to the Corporation's net income before income tax. This difference results from the following items:

	Fourteen months ended December 31 1997	Year ended October 31 1996
Combined federal and provincial income tax rate	44.6%	44.6%
Expected tax provision (recovery)	$ 801,000	$ 4,000
Increase (decrease) in income taxes resulting from:		
Benefit of prior year losses	(472,000)	(12,000)
Resource allowance	(343,000)	(14,000)
Non-deductible royalties and mineral taxes	198,000	22,000
ARTC	(129,000)	-
Benefit of tax pools in excess of book values	(60,000)	
Other	5,000	-
Provision for income taxes	$ -	$ -

The Corporation has cumulative income tax deductions totaling approximately $25,600,000, including reported non-capital losses for income tax purposes of approximately $327,000, which expire in the years 2000 to 2003. The cumulative income tax deductions exceed the net book value of related assets by approximately $15,700,000. The income tax benefit of these deductions has not been recognized in these financial statements.

Corporate tax returns are subject to assessment by taxation authorities in the normal course of business. The results of any assessments will be accounted for as a charge to earnings in the period in which they occur.

8. Commitment:

The Corporation is required to make the following approximate payments for leased premises:

1998	$ 59,600
1999	59,600
2000	62,700
2001	66,400
2002	11,200

9. Financial instruments:

(a) Credit risk:

A substantial portion of the Corporation's accounts receivable are with customers and joint venture partners in the petroleum and natural gas industry and are subject to normal industry credit risks. Purchases of the Corporation's natural gas, crude oil and natural gas liquids are subject to an internal credit review to minimize the risk of non-payment.

(b) Fair values:

The fair values of the Corporation's monetary assets and liabilities approximated their carrying values at December 31, 1997.

10. Comparative figures:

Certain of the 1996 comparative figures have been reclassified to conform with the financial presentation adopted in 1997.

We'd like to hear from you.

NAME ______

TITLE ______

COMPANY ______

ADDRESS ______

______

CITY ______

PROVINCE / STATE ______ CODE / ZIP ______

PHONE ______ FAX ______

E-MAIL ______

Check one:

- ☐ Add me to your mailing list.
- ☐ Update my information.
- ☐ Delete me from your mailing list.

Check as many as apply:

I am a(n)

- ☐ Current Shareholder
- ☐ Registered Shareholder
- ☐ Individual Investor
- ☐ Analyst
- ☐ Stockbroker
- ☐ Researcher
- ☐ Investment Advisor
- ☐ Portfolio Manager

Other ______

Please fill out this card and return it to us by fax (**403-266-0076**) or mail (address on reverse).

ASE: SCO

Director
Executive Vice President,
Vermilion Resources Ltd.

***Tibor Fekete**, P.Eng.
Director
President, Synerg Resources Ltd.

Robert A. Lehodey, BSc. Chem. Eng., LLB.
Corporate Secretary
Partner, Bennett Jones Verchere

Gerald J. Wendland, P.Geol.
Vice President, Exploration
Scarlet Exploration Inc.

* Member of Audit Committee

Key Personnel

Alan D. Jack, P.Eng.
President & Chief Executive Officer

Gerald J. Wendland, P.Geol.
Vice President, Exploration

Nora Blakney, CMA
Controller

Shaunna Haas
Manager, Corporate Affairs

Canadian Imperial Bank of Commerce
Calgary, Alberta

Engineering Consultant

Sproule Associates Limited
Calgary, Alberta

Legal Counsel

Bennett Jones Verchere
Calgary, Alberta

Registrar and Transfer Agent

Montreal Trust
Calgary, Alberta

Share Listing

The Alberta Stock Exchange
Symbol: **SCO**

SCARLET EXPLORATION INC.

2500, 520 - 5th Avenue SW,
Calgary, Alberta T2P 3R6

Phone (403) 266-0881

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Web site: www.scarletexploration.com

SCARLET
EXPLORATION INC.

Ms. Shaunna Haas

Manager, Corporate Affairs

SCARLET EXPLORATION INC.

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joint venture partners in the petroleum and natural gas industry and are subject to normal industry credit risks. Purchases of the Corporation's natural gas, crude oil and natural gas liquids are subject to an internal credit review to minimize the risk of non-payment.

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CORPORATE INFORMATION

Directors & Officers

***Alan D. Jack**, P.Eng.
Chairman & Chief Executive Officer
President, Scarlet Exploration Inc.

***Ian C. Barrett**, CA
Director
President, RCI Ltd.

***Lorenzo Donadeo**, P.Eng.
Director
Executive Vice President,
Vermilion Resources Ltd.

***Tibor Fekete**, P.Eng.
Director
President, Synerg Resources Ltd.

Robert A. Lehodey, BSc. Chem. Eng., LLB.
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Auditors

KPMG
Chartered Accountants
Calgary, Alberta

Bankers

Canadian Western Bank
Calgary, Alberta

Canadian Imperial Bank of
Commerce
Calgary, Alberta

Engineering Consultant

Sproule Associates Limited
Calgary, Alberta

Legal Counsel

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1997 ANNUAL REPORT

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